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Outlook for the Economy and Real Estate

Forecasting & Policy
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Changing of the Guard:
Economic Commentary

by

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As most economists do sometime in their careers, I was caught in one of those unfortunate predictions last month. For most of the first half of this year, I was forecasting that the major economic event of 1987 would be the naming of the Federal Reserve Chairman (true), and that if Paul Volcker were not reappointed economic disaster would soon follow (false). Well, Alan Greenspan has been appointed, and the sun (and the Dow) continues to rise each day. It's probably appropriate to take a little more thorough look at what actually has changed, where Mr. Greenspan will take the Fed, and what that implies for the economy and for real estate.

To begin with, no Fed Chairman is fully independent. The importance which the markets put not only on his words but also the phrasing and intonation of those words will inevitably force the Chair to speak very carefully and conservatively. Moreover, the opinions allowed to an outside consultant who can pack up and move on to the next client are not allowed to the head of the world's most central bank. Finally, the current Board is heavily oriented to a supply-side view of the world, and their opinions will be felt in all policy dicussions. All this suggests that Mr. Greenspan's past is not an infallible guide to his future.

With the caveat, several suppositions can be made about the direction of the Greenspan Fed:

1. Fighting inflation will remain a high priority. Those who suggest that Greenspan will tilt more toward growth than did Volcker ignore his history. When at the Council of Economic Advisors in the Ford Administration, Greenspan espoused strong anti-inflation policies even when such were not popular. While the ill-fated "WIN" campaign was the result of these, nevertheless, Greenspan has shown by deeds the depth of his commitment to fighting inflation.

2. The budget deficit will be an object of attack. Much more so than Mr. Volcker, Alan Greenspan has spoken against the deficit. It is likely that the Fed will line up even more firmly in the anti-deficit camp than it has. The unfortunate part of this is that it is unclear where Mr. Greenspan can apply this pressure for it to have any effect.

3. The Fed will shift to the side of deregulation. Under Volcker, the Fed was firmly against the expansion of financial powers, arguing that such expansion was inappropriate and dangerous. Mr. Greenspan has long been an outspoken supporter of an unregulated financial market, one in which full powers are available to all types of institutions. While this view cannot be as strongly held at the Fed, look for a clear movement away from the Volcker position.

What does all this mean for the economy and housing? Fortunately, Greenspan's appointment warranted only a slight hiccup in financial markets. The dollar has firmed up and the trade balance is clearly improved. This suggests that we will see a pause in growth as the manufacturing sector, stimulated by a more clement international climate, accelerates and takes the lead in the expansion from the flagging consumption sector. That means Mr. Greenspan will not likely be called on in the first several months of his term to make any major policy moves. What we can expect is a slow repositioning of the Fed to reflect his priorities and those of his fellow board members.

For housing, we're looking at "more of the same." Demand will remain strong, and in the face of stable interest rates, so will housing starts and sales. This is a most extraordinary year, not because it will set records, but rather because in the fifth year of a housing expansion, the market still has a great deal of steam.

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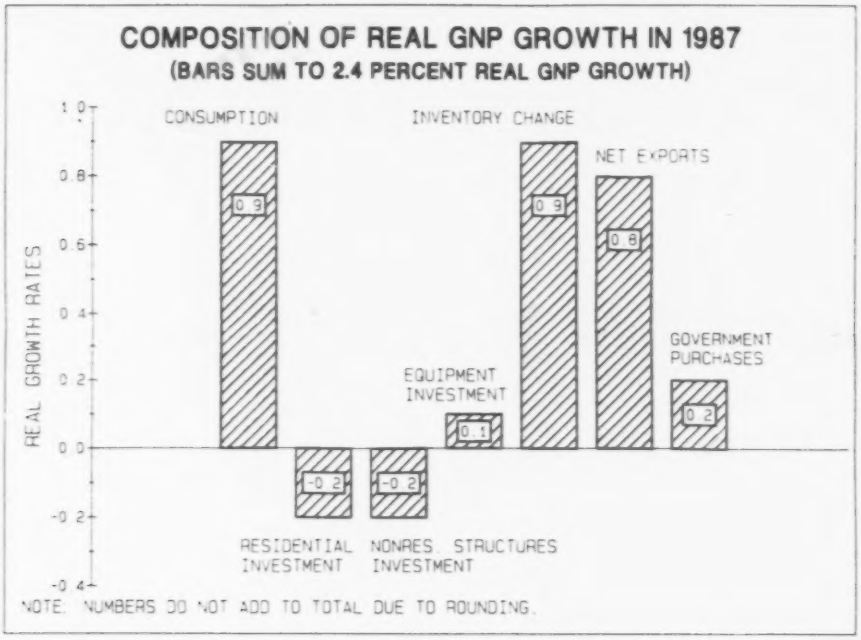
The Outlook for the Economy and Real Estate

Economic growth in the second quarter will not come close to the 4.8 percent annual growth rate of the first three months, but this does not imply that the economy is fundamentally different from the first quarter. "Muddling through" remains the catch phrase as overbuilding of inventories, the biggest source of first quarter growth, will force businesses to hold back on this investment in the current quarter. Net exports also contributed strongly to real GNP growth in the first quarter, and will probably do so again in the second quarter. The second half of the year could see less growth in net exports if the current forecast of a firmer dollar (145 to 150 yen) is played out. Normally the dominant source of growth in recent years, big-spending consumers have been conspicuous by their absence in late 1986 and early 1987. This was partly due to buying to beat tax reform, and the large incentives offered by automakers last fall. Renewed strength in consumption is expected to supply the bulk of economic growth in the remainder of 1987, helping the economy to reach the 2.4 percent real GNP growth forecast.

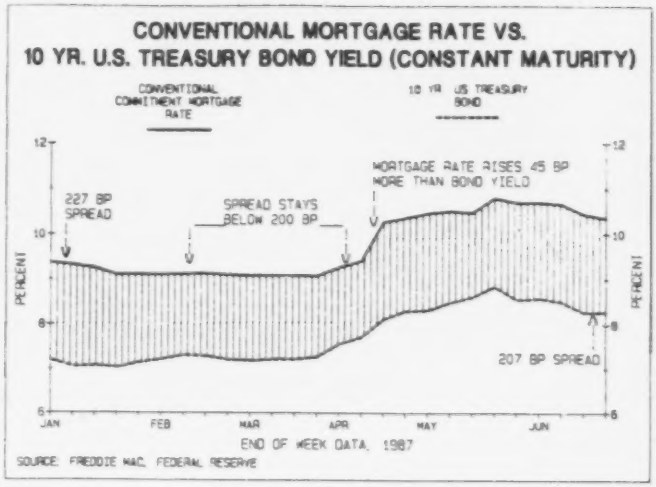
The chart below presents a snapshot of how the economy is expected to look in 1987. Sectors that are expected to contribute positively to real GNP growth throughout the year are consumption, inventory investment and net exports.



The silver lining of this slow growth forecast is that it whittles away expectations of higher inflation that had fueled a run-up in long term interest rates since late March. That rise in long term rates, which sent the bond market into a tail spin, occurred partly because government reports indicated higher inflation and there was a great deal of uncertainty over the direction of the dollar and the conduct of monetary policy. Since then, inflation-fearing investors have been calmed by sluggish economic indicators, and by a dollar made firmer on the news of real and nominal improvements in trade flows. Also, U.S. interest rates remain 5 to 6 percent above rates on comparable investments in Japan and West Germany. Therefore, the expectation of a firmer dollar reduces the likelihood of immediately higher inflation through increases in import prices in the second half of 1987. The only other route into the economy for inflation to follow is a new wage-price spiral. The fact is, final demand in the U.S. is just not hot enough to ignite such a spiral. The consumer price inflation forecast remains moderate at 4.0 percent in 1987, and 4.1 percent in 1988.

In light of this moderate inflation/firmer dollar forecast, Mr. Greenspan might have a little room to boost money supply growth in late 1987 and early next year. This is not in agreement with the political pundits who wager that in an election year Mr. Greenspan will be more attuned to White House communiques on the economy than was Mr. Volcker. It seems likely that Mr. Greenspan's knowledge and credibility within the financial community will afford him relative independence from election year politics.

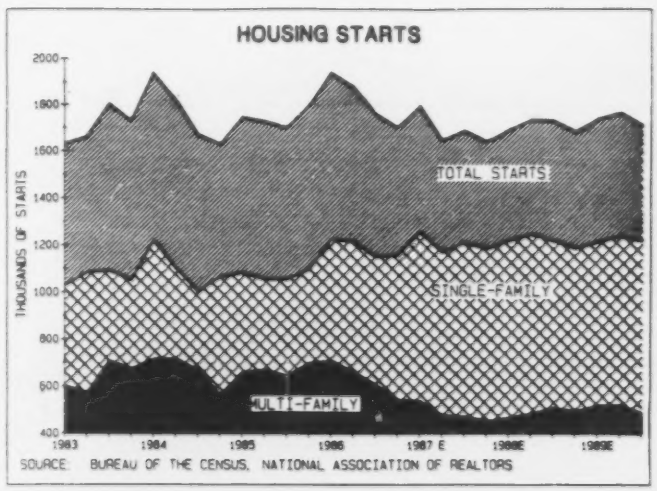
Still, if the dollar continues to trade at 145 yen or higher and inflation remains under control, then the Fed might consider a bit faster money growth. This is the assumption of the current forecast, which would lead to some softening in short term rates. Concurrently, a modest bond market rally is expected which would help pull long term mortgage rates down to 9.4 percent by the fourth quarter, and to 9.1 percent in 1988. The chart shows the historical relationship between the conventional commitment mortgage rate and the yield on U.S. Treasury bonds. As expected, the mortgage rate is very responsive to upward movements in Treasury bond yields, but is somewhat slower to follow the Treasury bond to lower levels. Currently, mortgage rates are slowly trending downward in response to lower bond yields.



Real Estate Markets

Housing Starts

Housing starts have now fallen for three consecutive months because of higher mortgage interest rates and continued weakness in multi-family starts. In May, housing starts fell to 1.62 million units from 1.665 million units in April and 1.730 million units in March. Single-family units were started at a seasonally adjusted annual rate of 1.129 million units, 7.6 percent below the April rate of 1.222 million units. Single-family starts are expected to rise back above 1.2 million units in the third quarter before trailing off in the final quarter for a 1987 total of 1.206 million units. Both 1988 and 1989 appear to be better years for housing starts activity because of lower mortgage interest rates.



Multi-family units were started at a rate of 416 thousand units in May, compared to 378 thousand units in April. This was the first monthly rise in multi-family starts since January 1987. This could be the beginnings of a gradual recovery in multi-family starts after they declined in response to the latest tax reform bill and high vacancy rates. Multi-family units are expected to be started at a rate of 486 thousand units in 1987 and 490 thousand units in 1988.

Existing Home Sales

Sales of existing single-family homes continued at a very strong annual rate of 3.74 million units in May, up 5.1 percent from April and 8.1 percent above the May 1986 rate. It appears that many homebuyers were able to hold on to the low commitment rates of late March, giving the appearance that existing home sales were not affected by the interest rate surge. Resales appeared to gain some strength in the South and West regions, perhaps because investors believe home prices in the oil-producing states have reached bottom and will soon begin to rise.

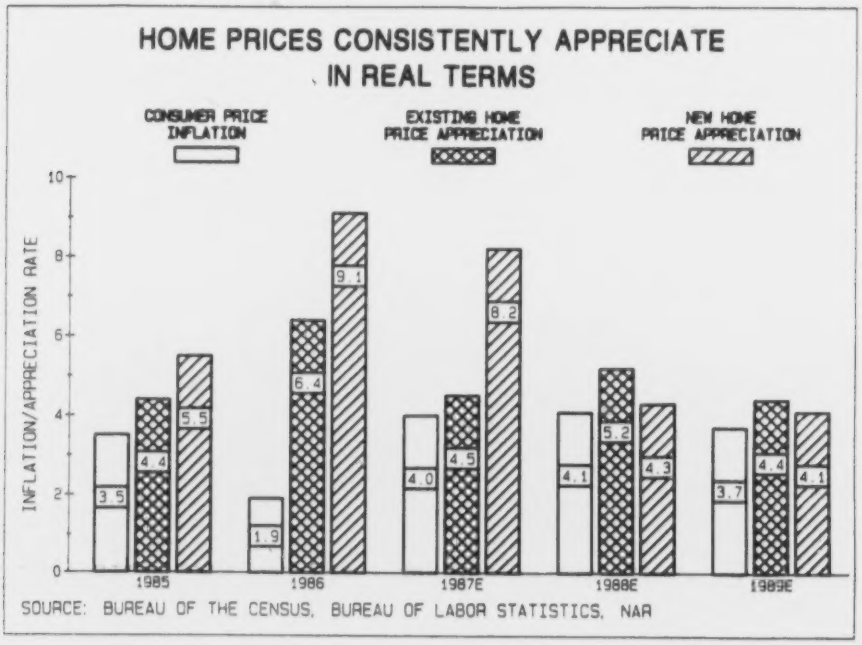
But an adjustment to the interest rate rise is certainly in store. We expect this adjustment to take place mostly in the third quarter as existing homes are sold at the slightly lower rate of 3.41 million units. Much lower home sales rates are not likely given the present stability in mortgage rates and the much higher prices on new homes for sale (see below). Existing home sales should then increase to 3.44 million units in the fourth quarter for a 1987 total of 3.51 million units. Both 1988 and 1989 are expected to be stronger years for existing home sales with activity forecast in the 3.6 to 3.7 million unit range.

New Home Sales

New home sales were affected quickly and substantially by the surge in mortgage rates. In May, new single-family homes were sold at an annual rate of 616 thousand units, almost 21 percent below the May 1986 rate and a 14.9 percent retreat from the April 1987 rate of 724 thousand units. The April rate was itself revised down from a preliminary rate of 777 thousand units. This large drop in May new home sales was accompanied by a report that the median new home price had jumped over 9 percent. This does not mean that new homes are in strong demand, but rather that those buyers able to afford a new home after the mortgage rate rise were wealthier individuals who tended to purchase more expensive homes. Therefore, the 1987 forecast of 680 thousand new home sales is more indicative of the strength of the first quarter (a rate of 711 thousand units), than more robust activity later this year. The slow decline in mortgage rates forecast through 1988 should be enough to boost new home sales to 723 thousand units in that year.

Existing and New Home Prices

Both existing and new home prices should appreciate in real terms (faster than inflation) over the forecast horizon. In 1987, new home prices will probably appreciate faster than those of existing homes, but not because new homes are in greater demand. As explained above, the interest rate surge forced many new home shoppers to consider purchasing an existing home because the lower prices presented a better value. Those left in the new home market tended to be more willing to pay the higher price for a new home. While the more affordable existing home market will likely experience less home price appreciation this year, existing home prices will still appreciate in real terms. This slower price appreciation is helping homebuyers adjust to the interest rate surge and will help maintain demand for existing homes over the forecast interval. In 1988 and 1989, new home prices will probably rise at slower rates because builders will be trying to revive market demand.



U.S. ECONOMIC OUTLOOK

	QUARTERS							YEARS				
	Actual		Forecast					Actual		Forecast		
	1986.4	1987.1	1987.2	1987.3	1987.4	1988.1	1988.2	1988.3	1985	1986	1987	1988	1989
AGGREGATE ECONOMY													
Gross National Product (billions of dollars)	4,259	4,352	4,402	4,466	4,534	4,603	4,661	4,729	3,998	4,206	4,439	4,699	4,993
% Change	1.7	9.1	4.7	5.9	6.2	6.2	5.1	5.9	6.2	5.2	5.5	5.9	6.3
% Change (w/out inflation)	1.1	4.8	0.8	2.3	2.6	2.0	2.2	2.8	2.7	2.5	2.4	2.3	2.8
Consumer Prices (CPI)	2.9	5.3	4.9	4.4	4.3	4.6	4.1	4.1	3.5	1.9	4.0	4.1	3.7
GNP Deflator	0.7	4.2	3.7	3.6	3.5	4.1	2.9	3.1	3.3	2.6	3.1	3.5	3.4
Unemployment Rate (%) (civilian)	6.8	6.7	6.3	6.3	6.3	6.4	6.4	6.3	7.2	7.0	6.4	6.3	6.1
Civilian Employment - Household Basis (millions)	110.4	111.3	112.1	112.5	112.9	113.3	113.7	114.1	107.2	109.6	112.2	113.9	115.5
% Change	1.6	3.1	3.1	1.4	1.6	1.2	1.5	1.6	2.0	2.3	2.4	1.5	1.5
Manufacturing Capacity Utilization	79.8	79.7	80.2	79.9	79.9	79.8	79.8	80.0	80.3	79.7	80.0	79.9	80.4
Domestic Auto Sales	7.9	6.8	7.1	7.3	7.2	7.2	7.5	7.6	8.2	8.4	7.1	7.5	7.7
Federal Tax Receipts (NIPA)	854.5	872.8	918.3	895.7	909.6	930.6	945.6	950.3	786.9	826.9	899.1	948.9	1011.3
% of GNP	20.1	20.1	20.9	20.1	20.1	20.2	20.3	20.1	19.7	19.7	20.3	20.2	20.3
Federal Expenditures (NIPA)	1043.4	1043.3	1048.4	1058.4	1077.9	1085.6	1098.5	1115.0	984.9	1030.3	1057.0	1107.9	1155.3
% of GNP	24.5	24.0	23.8	23.7	23.8	23.6	23.6	23.6	24.6	24.5	23.8	23.6	23.1
Deficit(NIPA)	-188.8	-170.4	-130.1	-162.7	-168.3	-155.1	-152.9	-164.7	-198.0	-203.4	-157.9	-159.0	-144.0
% of GNP	-4.4	-3.9	-3.0	-3.6	-3.7	-3.4	-3.3	-3.5	-4.9	-4.8	-3.6	-3.4	-2.9
REAL ESTATE MARKETS													
HOME SALES													
Total Single-Family Home Sales (1000, single-family resales plus 97 percent of single-family starts)	5,014	4,835	4,715	4,587	4,590	4,686	4,821	4,840	4,254	4,717	4,682	4,793	4,881
Percent change -- year ago	9.9	7.9	1.2	-2.5	-8.5	-3.1	2.2	5.5	8.5	10.9	-0.1	1.8	1.1
Existing Single-Family Home Sales (1000)	3,890	3,617	3,580	3,410	3,440	3,500	3,610	3,656	3,214	3,565	3,512	3,610	3,683
Percent change -- year ago	6.6	9.9	3.0	-4.9	-11.6	-3.2	0.8	7.2	12.1	10.9	-1.5	2.8	2.0
Housing Starts	1702.3	1794.7	1648.0	1685.9	1638.1	1689.9	1734.2	1729.5	1742.3	1819.2	1691.7	1709.7	1735.4
Percent change -- year ago	-5.3	-7.4	-12.3	-4.1	-3.8	-5.8	5.2	2.6	-1.4	4.4	-7.0	1.1	1.5
Single-Family Units	1158.7	1255.7	1169.9	1213.7	1185.2	1222.3	1248.4	1220.5	1072.6	1188.1	1206.1	1220.1	1235.4
Percent change -- year ago	5.6	2.4	-3.9	5.5	2.3	-2.7	6.7	0.6	-2.4	10.8	1.5	1.2	1.3
Multi-Family Units	543.7	539.0	478.0	472.2	452.9	467.6	485.8	509.0	669.7	631.2	485.5	489.6	500.0
2-4 Family Units	88.0	80.0	77.4	76.4	73.3	75.7	78.6	82.4	93.4	85.4	76.8	79.5	81.2
Percent change -- year ago	7.8	-16.7	-4.5	-0.3	-16.7	-5.4	1.6	7.8	-23.3	-8.6	-10.1	3.5	2.1
5+ Family Units	455.7	459.0	400.6	395.7	379.6	391.9	407.1	426.6	576.2	545.8	408.7	410.1	418.8
Percent change -- year ago	-26.3	-25.4	-31.0	-25.6	-16.7	-14.6	1.6	7.8	5.5	-5.3	-25.1	0.3	2.1
New Single-Family Home Sales (1000)	711	711	653	673	684	712	727	737	688	749	680	723	745
Percent change -- year ago	0.6	-9.9	-17.8	-1.9	-3.8	0.1	11.3	9.5	7.7	8.9	-9.2	6.3	3.0
Mobile Homes Shipped (1000)	243	234	249	257	255	257	265	269	283	249	249	267	316
HOME PRICES													
Existing Home Prices - Median ($1000)	80.2	84.2	84.8	82.8	83.6	85.8	87.5	89.1	75.5	80.3	83.9	88.3	92.2
Percent change -- year ago	4.7	7.6	4.7	3.4	2.2	1.9	3.2	7.6	4.4	6.4	4.5	5.2	4.4
New Home Prices - Median ($1000)	95.0	98.6	101.0	99.0	99.6	102.4	103.6	104.8	84.3	92.0	99.5	103.8	108.1
Percent change -- year ago	9.4	11.7	9.9	5.9	4.8	3.9	2.6	5.9	5.5	9.1	8.2	4.3	4.1
Mortgage Payment	535	532	595	562	557	562	578	574	631	559	564	573	588
NAR Affordability Index	109.3	110.3	107.8	104.8	105.4	106.1	106.3	107.4	94.8	105.7	107.1	106.8	107.3
Dollar Volume (billions)	388.4	373.1	375.9	360.2	364.9	376.0	388.8	396.5	291.9	351.1	368.5	389.9	405.1
FINANCIAL MARKETS													
Long-Term Interest Rates (%)													
30-year Fixed Rate Mortgage	9.4	8.8	10.0	9.6	9.4	9.2	9.3	9.0	12.2	9.9	9.5	9.1	8.9
1-year ARM (without buydown)	8.3	8.1	8.0	8.1	8.1	8.0	7.9	7.8	7.6	7.9	8.1	7.9	7.8
Corporate AAA Bond Rate	8.7	8.4	9.2	8.8	8.6	8.4	8.4	8.2	11.4	9.0	8.7	8.3	8.1
Government Bond Rate	7.5	7.5	8.6	8.1	7.9	7.8	7.9	7.6	10.8	7.8	8.0	7.7	7.5
Short-Term Interest Rates (%)													
Federal Funds Rate	6.3	6.2	6.7	6.6	6.5	6.5	6.5	6.8	8.1	6.8	6.5	6.7	7.1
3-month T-Bill Rate	5.4	5.5	5.7	5.7	5.7	5.6	5.6	5.7	7.5	6.0	5.7	5.7	6.0
Prime Rate	7.5	7.5	8.0	8.2	8.2	8.1	8.3	8.3	9.9	8.3	8.0	8.3	8.2
Discount Rate	5.5	5.5	5.5	5.5	5.5	5.4	5.9	5.9	7.7	6.3	5.5	5.8	6.1
Money Supply Growth -- percent change in M1	18.2	13.8	8.4	6.1	5.2	6.3	5.9	7.4	9.1	13.3	12.5	6.3	6.1
Value of the U.S. Dollar (Trade-Weighted Avg.)	107.0	99.9	97.2	99.6	100.6	98.6	96.5	95.0	143.2	112.3	99.3	96.0	93.7
Percent Change	-4.8	-24.2	-10.4	10.6	3.8	-7.7	-8.0	-6.2	3.5	-21.6	-11.5	-3.3	-2.5

Source: Forecast produced using Laurence H. Meyer and Associates' model of the U.S. economy.
Assumptions and simulations by Dr. John Tuccillo, Dr. Frederick Flick and Sean Burns.

EQUAL HOUSING OPPORTUNITY

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REAL ESTATE OUTLOOK

September/ October 1987

A Monthly Forecast for the Economy and Real Estate

FORECAST SUMMARY

- **Second quarter GNP grew** at an annual rate of 2.3 percent, revised down from 2.6 percent and barely half the 4.4 percent rate of the first quarter. Composition of second quarter GNP was more indicative of broad-based economic growth than the inventory driven figure of the first quarter.
- **The U.S. trade gap grew** to more than $15 billion in June, and the dollar's early August rally fell apart as a result. However, real net exports again contributed positively to economic growth, exceeding their first quarter level by $5.5 billion.
- **Renewed fears of high inflation** because of the dollar's sudden decline are unlikely to be borne out because of recent reports on inflation. However, foreign investors holding dollar-denominated assets may demand higher real interest rates be paid to them for accepting the exchange rate risk. This potential for higher real rates is the biggest risk factor for this forecast.
- **Existing single-family home sales remain remarkably strong,** in spite of a 175 basis point rise in mortgage rates during the first eight weeks of the second quarter. Both June and July resales were 7 percent above their respective one year ago levels.

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A NERVOUS SPLENDOR:
Economic Commentary

by
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Chief Economist and
Senior Vice President
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We've all had those periods, when, despite sunny days and green lights, a feeling of dread creeps into the psyche. It's nearly unconscious, but yet clearly there; surely intangible, but all too palpable. Well, welcome -- not to the Twilight Zone -- but to the American economy of the late Eighties. Despite the ample presence of good news, we can't help but feel that it can not last. How else can one explain the recent success of The Coming Depression of 1990, an exercise that George Bush could justifiably call "voodoo economics?"

Growth continues, and may in fact be accelerating. For the first half of 1987, the economy grew at a real rate of 3.2 percent, and will likely end the year having grown by 3 percent over 1986. In the sixth year of an expansion, that's very healthy. Inflation is up from last year, but still moderate. Prices in 1987 will have grown by about 4.2 percent, with not much sign of acceleration. From these conditions has sprung an unprecedented stock market surge that may ultimately take the Dow above 3,000. Unemployment is down; consumer spending is strong -- I could go on, but you get the picture.

Yet the feeling of dread hangs over the economy. Part of that has been induced by economists striving to be the first to call the recession. After all, reputations are not made by predicting more of the same. Be the first to call the turn, though, and everlasting fame and glory -- not to mention a weekly syndicated column -- can be yours.

But there are real reasons for dread. We suffered a crippling interest rate spike in April and we may well be on the verge of one now. There is a clear possibility that Mr. Greenspan will attempt to establish his inflation-fighter credentials by allowing rates to move upward. The weakness of this expansion has been the savings and investment balance. Higher rates now could close down the expansion by slowing down the growth of productive capacity.

Equally troubling is the way in which the domestic economy is tied to international markets. The April-May spike was set off by fears that the U.S. trade balance was deteriorating and that inflation would accelerate as a result. These fears proved groundless and markets calmed down. But we now lie in a world where the dollar sneezes and the mortgage market catches cold. This would all be fine if the balance of trade for the U.S. were level. In fact, the current imbalance has stubbornly resisted solution, and the dollar sinks even lower. More importantly, we are paying for our profligacy by transferring assets to foreign owners, and the more we need to do this, the more stringent the terms demanded by the transferee. In other words, the U.S. interest rates must rise.

So, pessimism about the economy has its place. All this need not occur, of course. The trade balance has improved in real terms and will respond in dollar terms when foreign producers find they cannot continually lower their goods prices to compensate for their higher-priced currency. If that occurs, the dollar will stabilize as will interest rates. Moreover, the third quarter statistics coming out in October may show weaker growth and persuade the Fed that monetary restraint is not an appropriate policy.

If all these things come to pass, the expansion will roll on at about the same pace, through 1988. The demographic and productivity fundamentals are good enough to maintain the status quo absent negative financial news.

The potential for an end to the expansion is clearly there. Yet it's too early to classify it as a certainty, although we have revised our interest rate forecast upward (see forecast description and special analysis "Risks to the Forecast" below). But despite the splendor and longevity of this expansion, there are some storm clouds on the horizon that bear very close watching.

OUTLOOK FOR THE ECONOMY AND REAL ESTATE

THE ECONOMY

The First Half of 1987

The broadest measure of economic activity, the GNP, grew at a 2.3 percent annual rate of growth in the second quarter, revised down from the preliminary 2.6 percent reported in July. This is scarcely half the 4.4 percent pace at which the economy grew in the first quarter, but while the recession watchers may still have their day, economic growth is expected to push onward at a modest pace over the forecast horizon.

The important difference between the second quarter figure and that of the first period is not so much magnitude as it is content. The second quarter GNP report listed consumption, business fixed investment and net exports as positive contributors, fighting to overcome the negative pull of reduced inventory investment. In addition, real federal purchases surged forward in the quarter due partly to the slower rate of price appreciation for those goods. The net result was a positive, though modest, GNP growth rate due to increases in final sales (GNP activity other than inventory investment). In contrast, the first quarter numbers told virtually the opposite story. Inventory investment combined with only one final sales component, net exports, to produce an attention-grabbing 4.4 percent growth rate; despite a decline in overall final sales.

Dynamics to Watch For in the Second Half

Although the second quarter figure paints a picture of more broad-based economic growth, there are several potentially troublesome developments to be on the lookout for in the remainder of 1987. First, the overall growth rate of real GNP is just enough to keep the economy moving forward, but far from what is needed for a renewed economic expansion. Despite being broad-based, second quarter growth relied heavily upon consumer spending. Residential investment is suffering from the higher interest rates, and could become particularly weak if the rate rise is due to higher real rates (see "Risks to the Forecast" section). Business fixed investment in structures remains very weak, but equipment spending has more than compensated for the shortfall. Government spending through the Commodity Credit Corporation (CCC) program will be a positive factor again in the fourth quarter. In sum, the hot spots in the economy are few, so the 2.5 percent growth projected for the second half depends on consumption spending and real net export growth in the third quarter, and equipment spending and inventory investment in the fourth.

Second, the $15 billion trade deficit reported for June was much higher than earlier monthly reports had led analysts to expect. Real net exports are still improving -- second quarter net exports improved $5.5 billion over the first quarter -- but a worsening of the nominal trade deficit could be a strong catalyst for harsh protectionist legislation. Economists are still searching for reasons why the trade imbalance has proven to be so stubborn. Tired after offering one traditional economic theory after another as explanations for the persistence of the trade deficit, economists now feel that the decline of the dollar alone may not be enough. These economists reason that the trade deficit itself means that the U.S. economy is spending more on purchases of imports than it is earning on sales of exports. They surmise that the complexities of our trade morass boil down to the timeless corollary: "If your outgo exceeds your income, then your upkeep will be your downfall." To repair the damage of this trend will take many years, but the first step, they argue, is to eliminate the federal budget deficit. By so doing, we will be removing a $180 - $200 billion dollar annual economic stimulus package that, through the multiplier effect, pushes present incomes (and expenditures) far beyond their actual level.

Third, these poor trade statistics have touched off another crisis of confidence among investors holding dollar-denominated assets. The dollar is slipping quickly back to the 140 yen/dollar range which could spark fears of renewed inflation. Central banks around the world have been reluctant to stem the dollar's slide. Outside the Fed, U.S. Government officials are being careful not to call for a stronger dollar, fearing tougher trade legislation from Congress might result.

Fourth, the possibility of an auto worker strike against either GM, Ford or both is being discussed as if it were already under way. GM fired off an incentive program that is likely to deplete auto inventories by the time a strike would likely begin. The move is viewed as a sign of confidence on GM's part that a strike can be averted. A strike is assumed to be averted in this forecast. Instead, as third quarter auto production enters its scheduled period of decline, the industry will contribute less to the economy in the way of production and more in the form of increased consumer durable spending. The incentive program will reinforce this effect, and without an auto strike to intervene, fourth quarter production will expand to restore depleted auto inventories.

Reduced Inflation Projected in Second Half

Inflation, as measured by the consumer price index (CPI), is expected to be more modest in the second half than projected in the previous forecast. The CPI is expected to rise by only 3.9 percent in the second half, bringing the inflation rate to 4.4 percent for 1987 on a fourth quarter over fourth quarter basis. This downward revision for inflation was done mainly to account for the lower inflation rates reported in each month from May through July. These lower rates have been the product of stable food prices and fluctuating oil prices showing little consistent upward potential for the remainder of 1987. In 1988, the CPI is ex-

pected to rise by an almost identical rate of 4.5 percent, on a fourth quarter over fourth-quarter basis.

Long-term Interest Rates Headed for Stable Period

Mortgage interest rates have been averaging well over 10 percent since late spring, and do not show signs of testing the 10 percent barrier in the foreseeable future. For example, conventional commitment rates for thirty-year mortgages with an 80 percent loan-to-value ratio have been hovering around 10.4 percent. We have changed our forecast to reflect this stubborn pattern. The current forecast expects mortgage rates to rise to 10.6 percent in the current quarter before stabilizing at around 10.5 percent for the fourth quarter of 1987 and most of 1988.

While inflationary expectations are certainly a part of this rise in mortgage rates, other factors are involved. Chief among these is the increasing interdependence of financial markets in many different nations. This trend toward globalization not only provides more knowledge of and access to worldwide investment funds, but it makes any one country's economy more susceptible to the economic and political events in another nation. The June trade deficit report is one recent example, but even less international government statistical releases help drive fiancial market opinions which in turn affect the level and direction of interest rates.

REAL ESTATE MARKETS

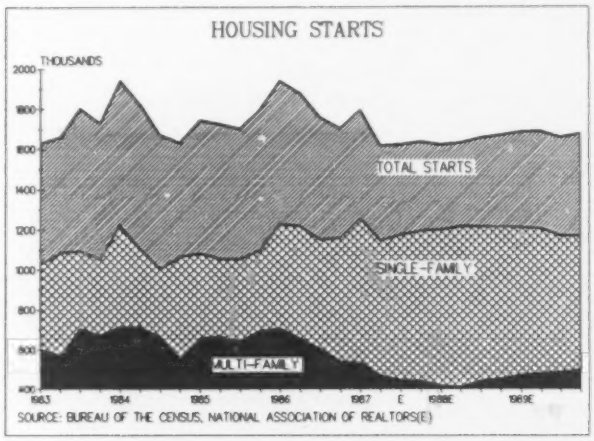
Housing Starts

After four consecutive monthly declines, the annual rate of total housing units started rose in July by 0.9 percent to an annual rate of 1.611 million units, 9.8 percent below July 1986. Since the February 1987 annual rate of 1.838 million units, housing starts had slowly declined to a 1.597 million unit annual rate in June. Whether or not this protracted slide in starts marks the beginning of a housing slowdown is hard to discern due to the interest rate surge.

The weakness in starts extends to both single- and multi- family units. In July, single-family units were started at a seasonally adjusted annual rate of 1.159 million units, up 5.7 percent from the June rate of 1.096 million units. The July rise was the first increase since February 1987, when single-family starts were moving forward at a 1.303 million unit pace.

Multi-family units were started at a seasonally adjusted annual rate of 452 thousand units in July. This was the third time multi-family starts were below the 500 thousand unit level. The July annual rate was 9.8 percent below the 501 thousand unit pace of June 1987, and 27.1 percent behind the July 1986 annual rate.

Total housing starts are expected to reach a seasonally adjusted annual rate of 1.619 million units in the third quarter and 1.635 million units in the fourth quarter. For all of 1987, housing starts could total 1.666 million units. Single-family starts are projected to reach an annual rate of 1.172 million units in the third quarter, and 1.193 million units in the fourth quarter. These quarterly projections would bring single-family starts to a 1987 total of 1.191 million units. Multi-family units are not expected to snap out



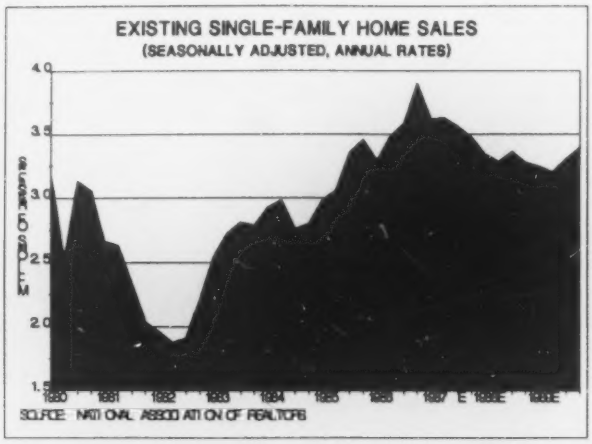
of their prolonged slump for the duration of the forecast horizon. As a result, multi-family units are expected to continue their decline through the rest of 1987, with total starts for the year only reaching 475 thousand units.

Existing Home Sales

Existing single-family home sales are finally showing some measurable reaction to the generally higher levels of interest rates experienced since late March. The July seasonally adjusted annual rate of resales reached 3.53 million units, a 0.9 percent increase from the June annual rate of 3.50 million units. Both of these figures are about 7 percent below the May 1987 annual rate of 3.77 million units, reflecting the interest rate surge. Both the June and July 1987 resale rates are 2.0 percent above their year ago levels, and 1.82 million existing single-family homes were actually sold in the first half of 1987, a 6.3 percent rise over 1986.

These statistics are surprisingly strong, considering the housing industry weathered a 175 basis point rise in mortgage rates during the first eight weeks of the second quarter. The question nobody wants to ask is how long can existing home sales continue at such strong rates? Existing homes are projected to be sold at about a 3.56 million unit annual rate in the third quarter before retreating slightly in the fourth quarter to a 3.48 million unit annual rate. For all of 1987, this works out to be a projected annual total of about 3.57 million units. Resale activity will probably decline slightly to about 3.31 million units in the first half of 1988 in response to the new levels of interest rates. Barring another sudden surge in interest rates, sales of existing single-family homes should post a solid 3.32 million unit rate in 1988.

Paying attention to only the nominal interest rate in 1988 could lead to some overestimations of resale activity. That is why the current forecast carries a special section discussing the factors behind pressures for higher real rates of interest (adjusted for inflation). There is the potential for the relatively high nominal rates of today to move higher as a



consequence of increasing real interest rates. This forecast is particularly sensitive to the forecasted path of inflation and the related issue of real interest rates (see "Risks to the Forecast Section").

New Home Sales

New single-family homes were sold at an annual rate of 653 thousand units in July, a scant 0.5 percent rise from the 650 thousand unit rate of June. More importantly, the July rate is 5.5 percent below the 691 thousand unit annual rate of July 1986, and the June rate was 15.6 percent below the June 1986 rate. The first half of 1987 posted an average annual rate of 700 thousand home sales, 11.6 percent below the 1986 first half annual rate of 792 thousand sales.

Sales of new single-family homes are still reeling from the interest rate surge of the spring. Unlike existing home sales, new home sales reacted after little more than one month following the mortgage rate spike. The higher cost of a new home relative to existing homes caused many potential new home buyers to substitute into existing homes in order to qualify at the higher interest rate levels. But just as an accurate assessment of how much housing starts have fallen due to the interest rate rise is difficult, so too is it difficult to distinguish between a general weakness in new home sales and the interest rate spike.

Prospects Good for Home Prices to Appreciate in Real Terms

The inflation path projected in the current forecast has been revised downward for the second half of 1987. This does not necessarily imply an equal downward revision in real home price appreciation for that period. Should demand for existing homes remain strong as projected in this forecast, home prices should appreciate at about 6.7 percent in 1987, or at a real rate of about 2.0 percent. With a slight slowdown in existing home sales expected in 1988 due to higher interest rates and a weaker economy, home prices could appreciate by 6.1 percent. All but 1.6 percent of this rise would be absorbed by inflation.

New home prices are projected to appreciate as much as 12 percent in 1987, but this is a misleading statistic. A major reason for this rise is the smaller volume of new home sales expected in 1987 because of the interest rate rise. Those new homebuyers remaining in the market are more likely to have higher incomes and can afford a more expensive home. This is expected to bias the home price considerably in 1987, yielding the unusually high growth rate. New home price appreciation is expected to moderate considerably in 1988 to 5.1 percent as builders try to attract lost shares of middle-income buyers by restraining price increases.

RISKS TO THE FORECAST

The Value of the Dollar, Inflation, and Interest Rates

While it may sound as if we are hedging our forecast a bit too much by listing all of these variables as "risks" to the forecast, in truth their interraction is the real source of the risk. The $15 billion trade deficit reported for June dashed hopes of the dollar maintaining its recent gains to near the 150 yen level. The dollar has fallen about 6 percent against the yen following that report. Somewhat ironically, the dollar softening was due partly to beliefs that the Persian Gulf situation will not explode into a major military confrontation that would cutback oil supplies. Central banks around the world have done little to stem the dollar's most recent decline, generally reiterating support for international cooperation to maintain the dollar's value.

Further dollar declines could possibly bring about faster growth in net exports, but at a cost of much higher rates of inflation. The transmission mechanism is twofold. First, import prices will be pushed higher by a lower dollar that cuts into foreign producers' profit margins. Second, domestic manufacturers would gain greater latitude in their own price-setting behavior if their foreign competitors are forced to raise their prices.

But at the same time the falling dollar is helping American manufacturers, it is reducing the value of dollar-denominated assets held by foreign investors. In exchange for holding an asset that could decline in value, foreign investors are demanding and getting higher real interest rates on their investments. These already high real interest rates pose a serious threat to the housing industry. This is not to say that foreign investment is bad for housing, a good case for the opposite can be made. Rather, high real interest rates are a consequence of the persistent trade deficit which has been manifested in large foreign capital inflows. If real interest rates must continue to rise in order to continue to attract the needed foreign capital, then the housing projections made in this forecast could require significant adjustments.

U.S. ECONOMIC OUTLOOK

	QUARTERS								YEARS				
	Actual		Forecast						Actual		Forecast		
	1987.1	1987.2	1987.3	1987.4	1988.1	1988.2	1988.3	1988.4	1985	1986	1987	1988	1989
AGGREGATE ECONOMY													
Gross National Product (billions of dollars)	4377.7	4447.7	4505.7	4578.1	4646.7	4725.2	4813.0	4891.4	4010.3	4235.0	4477.3	4769.1	5107.1
% Change	8.6	6.6	5.3	6.6	6.1	6.9	7.6	6.7	6.6	4.5	6.8	6.8	7.0
% Change (w/out inflation)	4.4	2.3	2.1	3.1	2.1	3.0	3.1	2.5	3.3	2.2	3.0	2.7	2.7
Consumer Prices (CPI)	5.3	4.9	3.8	3.7	4.3	4.3	5.0	4.6	3.5	1.3	4.4	4.5	4.2
GNP Deflator	4.2	3.8	3.3	3.4	3.9	3.8	4.4	4.1	3.1	2.2	3.7	4.1	4.1
Unemployment Rate (%) (civilian	6.7	6.2	6.0	6.0	6.1	6.1	6.0	6.0	7.2	7.0	6.2	6.0	5.9
Civilian Employment-Household Basis (millions)	111.3	112.2	112.9	113.4	113.7	114.1	114.7	115.1	107.2	109.6	112.4	114.4	116.2
% Change	3.1	3.4	2.8	1.4	1.1	1.8	1.8	1.6	1.9	2.3	2.7	1.5	1.5
Mfg. Capacity Utilization	80.0	80.4	81.2	81.5	81.5	82.0	82.4	82.5	80.3	79.7	80.7	82.1	83.0
Domestic Auto Sales	6.7	7.0	8.3	6.6	7.1	7.4	7.5	7.5	8.2	8.2	7.2	7.4	7.6
Federal Tax Receipts (NIPA) as % of GNP	20.1	20.7	20.0	20.0	20.2	20.3	20.0	20.1	19.7	19.5	20.2	20.1	20.2
Federal Expenditures (NIPA) as % of GNP	24.0	7.1	8.4	6.6	7.1	6.2	5.5	6.1	7.4	10.3	6.6	6.2	5.7
Deficit(NIPA)	-170.5	-141.9	-177.1	-183.6	-172.0	-166.8	-177.3	-178.8	-196.0	-204.7	-168.3	-173.7	-153.3
as a % of GNP	-3.9	-3.2	-3.9	-4.0	-3.7	-3.5	-3.7	-3.7	-4.9	-4.8	-3.8	-3.6	-3.0
REAL ESTATE MARKETS													
HOME SALES													
Total Single-family Home Sales (1000,single-family resales plus 97 percent of single-family starts)	4835	4720	4695	4632	4506	4465	4535	4449	4254	4717	4720	4489	4435
Percent change -- year ago	7.9	1.4	-0.2	-7.6	-6.8	-5.4	-3.4	-4	8.5	10.9	-0.1	-4.9	-1.2
Existing Single-family Home Sales (1000)	3617	3610	3539	3475	3343	3285	3360	3275	3214	3565	3565	3316	3284
Percent change -- year ago	9.9	3.8	-0.8	-10.7	-7.6	-3.9	-5.6	-5.8	12.1	10.9	0	-7	-1
Housing Starts	1794.7	1615.3	1618.8	1635.2	1619.1	1628.7	1652.9	1666.7	1742.3	1819.2	1666	1641.8	1676
Percent change -- year ago	-7.4	-14	-7.9	-3.9	-9.8	0.8	2.1	1.9	10.2	-5.3	-3.9	1.9	0.3
Single-Family Units	1255.7	1144.7	1171.6	1193	1198.9	1216.3	1211.7	1210.7	1072.6	1188.1	1191.2	1209.4	1187
Percent change -- year ago	2.4	-5.9	1.9	3	-4.5	6.3	3.4	1.5	2.9	5.6	3	1.5	-3.6
Multi-Family Units	539	470.7	447.1	442.2	420.1	412.5	441.2	456	669.7	631.2	474.8	432.4	489.1
2-4 Family Units	80	73.7	70	69.2	65.7	64.6	69	71.4	93.4	85.4	73.2	67.7	76.5
Percent change -- year ago	-16.7	-9.1	-8.7	-21.4	-17.8	-12.4	-1.3	3.1	-29	7.8	-21.4	3.1	10.8
5+ Family Units	459	397	377.2	373	354.4	347.9	372.1	384.6	576.2	545.8	401.5	364.8	412.5
Percent change -- year ago	-25.4	-31.6	-29.1	-18.1	-22.8	-12.4	-1.3	3.1	37.4	-26.3	-18.1	3.1	10.8
New Single-family Home Sales (1000)	724	675	665	675	684	689	675	701	688	749	685	687	700
Percent change -- year ago	-8.2	-14.9	-3.1	-5.1	-5.5	2.1	1.5	3.9	7.7	8.9	-8.5	0.3	1.9
Mobile Homes Shipped (1000)	233.7	226.7	253.2	258.2	261.2	265.4	266.9	268.8	282.9	248.9	242.9	265.6	314.1
HOME PRICES													
Existing Home Prices - Median ($1000)	84.2	85.1	86.5	85.8	89.3	91.2	91.5	90.5	75.5	80.3	85.4	90.6	95.4
Percent change -- year ago	7.6	3.8	7.2	7	6.1	7.2	5.8	5.4	4.4	6.4	6.4	6.1	5.3
New Home Prices - Median ($1000)	97.4	103.2	106.1	105.3	108	109	108.4	107.9	84.3	92	103	108.3	113.6
Percent change -- year ago	10.3	12.3	13.5	10.8	10.9	5.6	2.2	2.5	5.5	9.1	12	5.1	4.9
FINANCIAL MARKETS													
Long-Term Interest Rates (%)													
30-year Fixed Rate Mortgage (FHA Secondary)	8.8	10.3	10.6	10.5	10.5	10.5	10.4	10.4	12.2	9.9	10.1	10.5	10.2
1-year ARM (without buydown)	8.3	8.1	8.1	8.3	8.3	8.4	8.3	8.1	7.6	7.9	8.2	8.3	8.1
Corporate AAA Bond Rate	8.4	9.2	9.5	9.4	9.4	9.4	9.4	9.3	11.4	9	9.1	9.4	9.1
Government Bond Rate	7.5	8.5	8.8	8.7	8.7	8.7	8.7	8.7	10.8	7.8	8.4	8.7	8.4
Federal Funds Rate	6.2	6.7	6.7	6.8	6.9	7	7.1	7.1	8.1	6.8	6.6	7	7
3-month T-Bill Rate	5.5	5.6	5.9	6.1	6.2	6.3	6.5	6.4	7.5	6	5.8	6.3	6.4
Prime Rate	7.5	8	8.3	8.3	8.5	8.7	8.8	8.8	9.9	8.3	8	8.7	8.8
Discount Rate	5.5	5.5	5.5	5.5	5.7	5.9	6	6	7.7	6.3	5.5	5.9	6
Money Supply (M1)(% change)	13.8	6.5	1.6	4.2	5.4	6.2	8.1	7.3	11.9	15.2	6.4	6.8	7.6
Value of the U.S. Dollar (Trade-Weighted Avg.)	99.9	97	98.5	97.8	97.5	96.9	96.9	96.7	143.2	112.3	98.3	97	95.9
Percent Change	-24.2	-11.1	6.5	-2.8	-1.3	-2.3	0	-0.8	-12.9	-16.5	-8.6	-1.1	-1.1

Source: Forecast produced using Laurence H. Meyer and Associates' model of the U.S. economy.
Assumptions and simulations by Dr. John Tuccillo, Dr. Frederick Flick and Sean Burns.

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